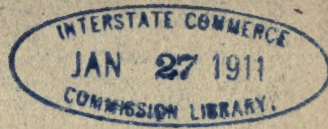


Hines, Walker Downer
Statement of Walker D.
Hines

HE
2236
H55



STATEMENT

OF

WALKER D. HINES

BEFORE

U. S. RAILROAD SECURITIES COMMISSION

AT

NEW YORK, DECEMBER 22, 1910.

C. G. BURGOYNE, 72 to 78 Spring Street, New York.

HE
2236
H55



930480

RAILROAD SECURITIES COMMISSION.

NEW YORK, December 21, 1910.

The Commission met 10:00 A. M.

Present :

MESSRS. HADLEY (Chairman), STRAUSS, MEYER, JUDSON, FISHER, and GRISWOLD (Secretary).

STATEMENT OF WALKER D. HINES.

The statement I have prepared deals with the more general considerations which the Commission has been discussing, as in the nature of a foundation of its work, rather than with specific suggestions or comments at this time on specific characters of regulation.

The Question of Constitutionality.

At the outset I want to say, without going into detail, that in my own opinion Congress has the power to regulate the capitalization of railroad companies engaged in interstate commerce, and that, personally, I am not disposed to offer any objection to the exercise of that power. While in the course of my statement I may point out why particular reasons which have been urged in the support of the power are not, in my opinion, valid reasons for its exercise, yet I recognize a general disposition on the part of the public to secure an adequate supervision over this subject, and personally I have no objection whatever to offer to that.

Broadly speaking, the object of a railroad company is to provide a channel for commerce. That is what it is created for. That is what a railroad is ; it is a channel for commerce.

And I take the broad position that the power which can regulate commerce can regulate the operations of the company whose object is to provide a channel for that commerce.

I do not care to go at present into details on the constitutional question. As I say, it is manifest that the public is going to insist on adequate regulation of the financial operations of these great corporations which are engaged in a quasi-public service. I think it is also manifest that state regulation is unequal and inadequate largely by reason of its inequality. Some states regulate too much and other states do not regulate at all.

Since the matter is far more a matter of federal concern than it is of state concern, it is easy to see how there should be a disposition to turn to the federal power for an adequate and uniform system of regulation.

This point, perhaps, is illustrated in this way: Take a railroad company incorporated in one state and running through ten states. On an average, three-fourths of all the commerce carried by that railroad is interstate commerce, and only one-fourth is intrastate commerce: perhaps only one-tenth of that one-fourth is in the state which undertakes to regulate the capitalization of that railroad. So here is a situation where the federal government, by reason of its jurisdiction over commerce among the states, has about thirty times as much interest as any one state through which that railroad runs.

I believe that considerations of that sort are bound to be very strong with the public in considering this question.

I think, too, it follows, from this very much greater interest which the federal government has in the subject, that eventually, and preferably at the outset, federal regulation should be exclusive. The constitution of the United States, of course, recognizes that the acts of Congress in pursuance of the constitution shall be paramount, and where the interest of the federal government is so many times greater than the in-

terest of any one state, it seems just and in the interest of uniformity and adequacy that eventually, and as soon as possible, federal supervision should be exclusive of state.

I want to suggest to the Commission that, if my view of the constitutional aspect of the matter is correct, there is no occasion in justifying this power to lay very much stress on a specific reason. The question occurs to me : Is there any occasion to narrow the basis of the regulation, when the power to regulate is just as broad as the object of the railroad ? The object of the railroad is to provide a channel for commerce. The power of Congress is to regulate commerce. That being true, the power being really co-extensive with the object of the railroad, is there any reason to narrow the reasons assigned for the regulation to some one detail ? I take it that so far as the matter is a matter of public interest in any aspect it comes within the object of the railroad company, and it therefore comes within the power of Congress to regulate commerce. And if narrowed to some specific reasons, the great danger is that there will be disproportionate weight given to those reasons, and the public will assume that there is a necessity to regulate for those reasons which the facts may not justify.

Nevertheless I wish to consider the specific reasons which have been urged in support of a supervision or regulation of capitalization by the federal government.

The Relation Between Capitalization and Rates.

The first point that I wish to consider in that connection is the effect of the capitalization on rates. It must be remembered that there are three distinct branches of that subject. The first one is the part which capitalization may play when a federal court comes to pass upon the validity of rates made by a state. In that sort of a case, the only question which the federal courts can consider is the question whether the rates

made by the state legislature or Commission are in conflict with the fourteenth amendment of the Constitution of the United States, or, as it may be, with the commerce clause, where they regulate interstate commerce ; but the commerce clause question is immaterial, for present purposes.

The next class of cases to consider is that where the court is called upon to pass upon the validity of rates made by the Interstate Commerce Commission. There, two questions are involved : Not merely the question whether the rates prescribed by the Interstate Commerce Commission are in conflict with the Constitution of the United States, as depriving the railroad company of its property without due process of law, but the additional question whether the rates prescribed by the Interstate Commerce Commission are in conflict with the statute which authorizes the Commission to act. The constitutional question is pretty well understood, because it is analogous to that which has been passed upon by the federal courts repeatedly in connection with the state rates. The statutory question is one which is much less understood, but which is very important.

The third class of cases in which the question of capitalization might be raised is that in which the Interstate Commerce Commission comes to pass upon the legality of rates made by railroad companies, and undertakes to correct such of those rates as are in conflict with the law ; and there, as I shall point out, we find an entirely different set of considerations to which attention must be given.

I will say, in general, before going into detail in considering these classes, that it cannot be denied that it is possible for the element of capitalization to be at least a theoretical element in any of these cases, but I wish, by as brief a statement as possible of the situation, to show that, generally, that relation is very remote ; that generally it does not exist at all, and when it does exist, it is remote.

Capitalization has Practically no Bearing in Cases Involving Merely the Question Whether Rates Made by State Authority Violate the Federal Constitution.

Let us take the first branch of the subject which deals with the principles applied by the federal court in determining whether rates made by State Legislatures or by State Commissions are in violation of the Constitution of the United States.

The only cases where state rates have been set aside because in conflict with the Constitution of the United States have been cases where a body of rates has been under consideration, and where the cases have been tried upon the theory that the rates prescribed by the state authority were insufficient to produce a fair return upon the present value of the property.

That is the only theory upon which the cases have been tried. The case of *Smyth vs. Ames* was an early example of that, and the latest example, perhaps, or the most important of the latest examples, is the Consolidated Gas case. In those cases the point was made very plain that the basis of the decision was the present value of the property and the return upon that property.

I wish to call attention further to the fact that in those cases the Supreme Court has never given any consideration to capitalization, except as an incident to ascertain the present value of the property. Even the emphatic statements in *Smyth vs. Ames* went no farther than that. Furthermore, in *Smyth vs. Ames* the court was careful to show that the question must have a relation to present value.

I call attention to this expression of the court (169 U. S., 554).

"If a railroad corporation has bonded its property for an amount that exceeds its fair value, or if its capitalization is

largely fictitious, it may not impose upon the public the burden of such increased rates as may be required for the purpose of realizing profits upon such excessive valuation or fictitious capitalization; and the apparent value of the property and franchises used by the corporation as represented by its stock, bonds and obligations, is not alone to be considered when determining the rates that may be reasonably charged."

A much more recent case in which reference has been made to that matter, is the case of *Knoxville vs. Water Company*, 212 U. S., 1. In that case the court said:

"Counsel for the company urged, rather faintly, that the capitalization of the company ought to have some influence in the case, in determining the valuation of the property. It is a sufficient answer to this contention that the capitalization is shown to be considerably in excess of any valuation testified to by any witness, or which can be arrived at by any process of reasoning. The cause for the large variations between the real value of the property and the capitalization in bonds and preferred and common stock is apparent from the testimony."

Then the court proceeds to point out that the large over-capitalization grew out of contracts with the persons undertaking to build the water works. Then the court goes on to say:

"Perhaps it is unnecessary to say that such contracts were made by the company with persons who, at the time, by stock ownership controlled its actions. Bonds and preferred and common stock issued under such conditions affords neither measure nor guide to the value of the property."

So it is very clear that the Supreme Court, in dealing with questions as to the constitutionality of state rates has not been influenced by capitalization at all, except when upon a full showing it was demonstrated that that was a fair index to the present value of the property; and of course that cannot be demonstrated, if it is contested, except by showing that value has been received for the stocks and bonds outstanding.

Thus, capitalization as a test of value was rejected in *Smyth vs. Ames*. At least, the argument was rejected. And capitalization was specifically rejected in the *Knoxville* case.

I wish to point out, further, that I cannot find a single case in which there is the faintest suggestion that any court has ever been misled by the nominal capitalization of a railroad company in considering these cases of the validity of state rates. Where it has been referred to, if it influenced the court at all, it has been on the avowed proposition that it represented the fair value of property.

That was stated, specifically, in the first case in which the Supreme Court set aside rates of a state. That was the *Reagan* case, 154 U. S., 362, where the court, in summarizing the matter, referred to the facts shown by the record, and said this :

“The cost of this railroad property was forty million dollars. It cannot be replaced today for less than twenty-five million dollars. There are fifteen million dollars of mortgage bonds outstanding against it, and nearly ten million dollars of stock. These bonds and stock represent money invested in the construction of this road.”

So the court there showed that the cost was forty million dollars, that the reproduction cost was twenty-five million dollars, and that all the stock and bonds outstanding represented money invested in the road. So that it was not misled by the nominal capitalization, but went to the root of the thing, as the court always does in these cases, and looked at the actual investment and the present value of the property.

I wish to say, too, that from my observation of suits brought to test the validity of state rates, I have never known of a single instance where capitalization was alleged in the bill as a reason for the invalidity of the rates, except where the capitalization was connected with the present value of the property. That has generally been the contention—that the property could not be reproduced for the capitalization, or

that the property was fully worth the capitalization. In any event it is apparent, from these cases, and strikingly so from the Knoxville case, which is one of the latest, that the court will pay no attention to capitalization unless to show present value, and that the burden to prove that is upon the railroad company.

So that I submit to the Commission that, on that branch of the cases, where the court has been called upon to pass upon the constitutionality of state rates, the relation of the nominal capital to the question of governmental regulation has been exceedingly remote, and has never played a substantial part; but that the court has always gone back to the question of the present fair value of the property.

It should be borne in mind that all of these cases I have been discussing are cases that were tried upon the theory that the rates attacked did not produce a fair return upon the present value.

I wish to call the attention of the Commission to the fact that, in my own opinion, that is not the only theory upon which the constitutionality of state rates can be attacked. It happens to be the only theory which the Supreme Court has ever sustained; but other theories are not foreclosed by any decision which the Supreme Court has made.

There has been a suggestion, and there was in the Reagan case, that there might be other considerations, and that even in considering merely the question of the constitutionality of state rates, the court might look at other things than the value of the property. For example, in the Reagan case, the court considered the question of present value, and also pointed out considerations of a different character, such as the fact that the rates had been reduced by the railroad companies from year to year, and were much lower than they had been in the past, thereby showing a tendency to go into the general question of reason-

ableness and propriety of the rates of the railroad company ; and said in general, after referring to matters relating to the cost of operation and the cost of construction, "that doubtless there are many other matters affecting rights of the territory in which the road is built, as well as the rights of those who have built the road." The point I wish to emphasize is that, while the cases affecting the validity of state rates have been tried on this theory of the return on present value, yet that the Supreme Court has never said that no other theory was admissible ; and in my opinion there are other theories of a broader character which, in proper cases, could be presented and would be entertained by the court.

In the case of *Smyth vs. Ames* there was quite an emphatic statement that present value must be the basis ; but that statement was made in response to the argument on the part of the railroad companies, that they were entitled, under all circumstances, to a fair dividend on all of the capital stock ; and in answering that statement, the court said present value must be the basis. But I think the court was deciding only the question before it, and that it has not foreclosed a broader consideration of these questions.

I wish to call attention in this connection to the fact that these railroad cases differ very radically from street railway, gas and water companies. The case of a street railway company or a gas company or a water company, comes into court on one rate for consideration, a rate for one commodity or service. The railway company's case may come either in the aspect of a body of rates covering all kinds of service, or a single rate covering one of many of those services.

When a railroad company challenges a rate made by a State Commissioner for only one, or a few of many thousand services, it is almost impossible to try that case, or test the validity of those rates, according to the returns upon the present value of the property, because it is impossible to ascertain

the cost of the particular service, or to make any very satisfactory connection between this service and the total service rendered or the total cost, or the total return.

It is the opinion of a good many eminent railroad lawyers, and I believe there is a great deal of merit in the view, that the courts will, especially in cases of that sort, apply different theories to this subject, and will hold that where rates are demonstrably reasonable on their merits, in view of all the circumstances, the railroad company may have a constitutional right to charge them, even though it cannot establish that the reduced rates complained of would prevent a fair return on the value of its property, as a whole.

I mention this simply to emphasize the situation that even as to this comparatively narrow class of cases where the validity of state rates has been attacked for unconstitutionality, there is not a final and exclusive theory upon the subject. Several cases have been tried on this one theory of the return on present value, but they do not cover, by any means, the entire philosophy of the problem as to when rates violate the constitutional provision that persons shall not be deprived of property except by due process of law.

It may not be improper, in that connection, to call attention to the fact that in the last week or two weeks, in an argument in the Supreme Court of the United States, where the government relied on these cases dealing with bodies of rates to sustain the proposition that where a single rate was under consideration the court could not entertain an attack upon its validity except upon a showing that the company did not make a fair return on the value of its property as a whole, one of the Justices, who has given a special attention to those cases, showed very marked impatience with that argument, and pointed out that those cases relating to bodies of rates were inapplicable to cases where only a few of a great many rates were under consideration.

I mention that just to support my suggestion that it is still

an open question, and has not been concluded, and confined to the one theory of a fair return, even as to the class of cases which involve solely the question whether rates of a legislature or Commission are so low as to violate the constitution.

Clearly, if cases shall arise where the constitutionality of State rates may be tested on other theories than that of a fair return on the value, the question of capitalization will be even less substantial than in the cases tried on the fair return theory.

These Cases Involving Constitutionality of State Rates Have Merely Held that a Fair Return is the Minimum Constitutional Return, and Not, as Popularly Supposed, that it is the Maximum Lawful Return.

I wish to call attention to another very important point in connection with these cases, where the court has overthrown state rates on the ground that they violated the federal constitution, and that is that those cases have gone no further than to say that if the rates prescribed are so low as to give the corporation less than a fair return on the fair value of its property, they are unconstitutional.

In other words, those cases have merely established a minimum below which rates cannot constitutionally go.

One of the most unfortunate elements in connection with the public discussion of this is that the public has been led to believe that those cases tend to establish a general rule that there is such a maximum above which rates cannot go, and that if rates go above the maximum, the rights of the public are violated. That is a most unfortunate impression that has been disseminated, and has considerably influenced public opinion at the present time. Here the courts, in the protection of property, to prevent the taking of property without due process of law, to prevent its being wrested from

its owners, have said that if you go below this point you commit this wrong on the railroad company ; and the public, unfortunately, is disposed to turn that right around, and say if the railroads go above that same point, they are committing a wrong on the public.

I think that in any promulgation by this Commission of a report on this subject it would certainly be in the interest of a clear understanding of this subject if it could be made clear that even in this class of cases, tried on this theory, the courts have done no more than to establish a minimum below which rates cannot constitutionally be reduced, and have not undertaken, at all, to prescribe the maximum up to which rates may be properly made.

Capitalization is Equally Unimportant in Cases Involving the Legality Under the Constitution and Under the Statute of Rates Made by the Interstate Commerce Commission.

Now we come to the second class of cases, where the court is called upon to consider the validity of rates which have been made by the Interstate Commerce Commission. There the court is called upon to pass upon this constitutional question, just the same, although as to rates of the Interstate Commerce Commission it arises under the fifth amendment, whereas as to state rates it arises under the fourteenth amendment. But the constitutional question is the same.

Then comes the statutory question. Granting that the rates do not violate the constitution, has the Commission violated its statutory duty, because the statute is not co-extensive with the constitution in this matter. The statute says that the Commission must prevent the railroad company from charging more than a just and reasonable rate ; but it does not refer to the constitutional provision for a definition of what is a just and reasonable rate. The constitutional provision

merely establishes the minimum, and above that is this whole region in which the question arises as to what a reasonable rate is, as to what is lawful under the statute.

As a rule, practically always with the exception of a general advance in rates, which I will refer to separately a little later, the Interstate Commerce Commission passes on only one or a few rates at a time, where it is out of the question to connect them with the matter of a return on the value of the property as a whole, in such a way as to give a reliable result, and where I suppose the Commission has realized that that is true.

I wish to call the Commission's attention further to the fact that the question as to the extent of the judicial review of the Commission's orders is a new question. It is unknown just what the law is in regard to it. The Commission was not given the power to prescribe rates until 1906. No case reached the Supreme Court where the Commission had prescribed the rate until October, 1909. The first case was a case involving the terminal rates to the Chicago stock yards, a rate of \$2 per car prescribed by the railroad company being reduced by the Commission to \$1 a car. The case went to the Supreme Court of the United States, and the government there insisted that the rule was established that rates fixed by the Commission could not be set aside as unlawful unless the railroad could show that the result of those rates was to deprive the railroad company of a fair return upon the present value of its entire property.

The Court absolutely ignored that argument in that case, and made no reference to it one way or the other in its opinion. It simply held that the rate which the Commission had fixed was unreasonable, under the circumstances.

That was a very peculiar case. The railroad showed that the cost of the particular service which they were rendering there was more than the \$2 which they had fixed as the rate. The Commission held that, nevertheless, if they consid-

ered the rate to Chicago, plus the terminal rate of \$1 which the Commission thought ought to be imposed, the total result would be a fair compensation for the service which the railroad companies got.

So the principal holding of the court was that the Commission could not combine two different things in that way ; that if it were undertaking simply to pass on the terminal rates, it had to confine itself to that. So that it cannot be said that that case is a clear authority for the position I am suggesting, but it is a clear authority against the other contention, that nothing can be considered except the return on the property as a whole.

Another case, not involving rates, but throwing some light upon the scope of the court's power of review, is *Interstate Commerce Commission vs. Illinois Central R. R. Co.*, 215 U. S., 452. This case, however, indicates that in such cases there is involved not merely the question whether the Commission's order violates the constitution, but the further question whether the Commission's order violates the statute.

In the Twenty-fourth Annual Report of the Interstate Commerce Commission, on page 16, there is a reference to the case of *Interstate Commerce Commission vs. Chicago, Rock Island and Pacific Railway Company, et al.*, 218 U. S., 88, in which the Commission says : "No claim was made by the carriers that their constitutional rights had been invaded, and the Commission insisted that this being so its order could not be reviewed by the Court. The Supreme Court of the United States sustained this contention, holding, in substance, that this case was governed by the *Illinois Central* case above referred to." This language may create the erroneous impression that the court held that no question was involved but the constitutional one. On the contrary, on page 110 of 218 U. S., the court expressly stated that its power was confined to a review of constitutional questions and of "all pertinent questions as to whether the action of

the Commission is within the scope of the delegated authority under which it purports to have been made."

There have been no other cases which have been passed upon by the Supreme Court involving rates made by the Interstate Commerce Commission which have thrown any light upon this subject. The case I referred to just now, where one of the Justices showed great impatience with this argument that the matter was controlled by the question of a return on the value of the property as a whole, was a case involving a rate of the Interstate Commerce Commission; and I assume that that case will be decided in a few months.

The point I wish to emphasize as to this branch of the case is that it is an unknown region, up to this time; that this Commission would not be justified in assuming that any one theory would be applied by the courts in order to test the validity of rates made by the Interstate Commerce Commission. Only one case has been passed upon, and that did not directly meet the question. So far as it went it showed a clear disposition to regard the theory applied to bodies of state rates as inapplicable; but it did not cover the question, so that it remains for the future.

It is very evident that this is the important class, and the only class, really, of great interest with which the federal courts have to deal—these cases where the Interstate Commerce Commission makes the rates; so that we are not in a position to assume, from any of the statements in the state cases that the question of capitalization will have as much to do with these Interstate Commerce Commission rates even as it has had to do with the state rates. And, as I have shown, that has been very, very little.

Really, when we come to the question of the powers of the Commission under the Interstate Commerce Act, and as to the powers of the court in revising rates by the Commission, we get back to the Commission's powers itself. We are bound to assume, until the courts decide to the contrary, that if the

Commission should, in a glaring case, exceed or violate its statutory power, even if it did not infringe on the constitutional provision, the court would set it aside; because the whole charter of the Commission's action is that statute. And if it goes beyond it, its action is void.

Capitalization Will Be Equally Unimportant in Proceedings Before the Interstate Commerce Commission to Determine Whether the Carriers' Rates Should Be Corrected.

This brings us to the third class of cases, and in this connection it will be interesting to consider briefly what the Commission's duty is under the Act to Regulate Commerce.

The Commission's duty under that act is merely to correct any violations of the law which the carriers may make. That brings us right back to what the carrier's duty is. The requirement of the Interstate Commerce Act is that rates shall be just and reasonable, and every unjust and unreasonable rate is prohibited. That is merely the requirement of the common law. That is the requirement that has been enforced by authority of the common law from the beginning of railroad companies.

The duty now of railroad companies is what it has been in the past, to make rates reasonable, just as it has been its duty in the past. The railroad companies now have the right, and are under an obligation to consider whatever elements it was their duty to consider in the past, in making rates. Of course, it is quite apparent that it has the right to consider a great many things besides its capitalization, and that it must consider them; and if that has been so in the past, it is still so; because the carrier's duty as to the reasonableness of rates under the Interstate Commerce Act is exactly the same as was its duty at common law.

It is evident that the Commission, when it comes to pass

upon a rate made by a railroad company, and to say whether that rate violates the railroad company's duty under the Interstate Commerce Act, should consider whatever elements the railroad company would consider in making that rate.

That is made clear in the Import Rate Case, 162 U. S., 197. This was a case decided before the Commission was given power to fix the rates, but while the Commission had power to issue orders to require railroad companies to change rates that were unreasonable ; and in this case the court said :

"The very terms of the statute, that charges must be reasonable, that discrimination must not be unjust, and that preference or advantage to any particular person, firm, corporation or locality, must not be unjust or unreasonable, necessarily imply that strict uniformity is not to be enforced, but that all circumstances and conditions which reasonable men would regard as affecting the welfare of the carrying companies, and of the producers, shippers, and the consumers, should be considered by the tribunal appointed to carry into effect and enforce the provisions of the Act."

I think it is clear from that, and it is clear from what the Interstate Commerce Commission has done from time to time in passing upon rates, that it is its duty to consider all circumstances and conditions which reasonable men would regard as affecting the welfare of the parties.

So that the powers and duties of the Commission with respect to making rates are very broad, and manifestly very much broader than the question of the return of dividends on stock.

The matter, really, turns on the factors which the carrier would have the right to consider.

I want to consider, as a separate proposition a little later on, this question of the general advance in rates, but let us take up, first, the consideration of rates in general which railroad companies make.

Railroad Rates are Not, and Cannot Be, Made on any Theoretical Basis.

You gentlemen are entirely familiar with the general principle of how rates are made. I think it can be illustrated, very briefly, by a situation which arose in Western Kentucky a great many years ago, when coal mines were first opened on the Henderson Division of the Louisville and Nashville Railroad. At that time the only fuel in that country was wood. These coal mines were opened. The railroad company wanted to make rates to haul this coal, which was a new traffic. Strange to say, the railroad company did not select anybody who knew anything about its capitalization to do that. It selected a very wise man who was operating coal mines down in that country, and said: "You find out what rates will move this traffic." And this gentleman went to work to find out what wood cost in the various towns on the road, and what was the equivalent in coal of a given amount of wood. He figured out, from that, what consumers of fuel in those towns would be willing to pay, in order to get coal instead of wood to burn. He figured out that the coal could be put on the cars for at the mines, and he figured out that the difference was the rate that the railroad company would have to charge to move the traffic.

That is typical of the way in which rates are made. The rates are made to move the traffic. They are made with no reference to dividends on stock.

Generally speaking, the last thing a traffic man thinks of is that subject. If he thought of it, it would be beyond possibility to make any apportionment between the hundreds of things that he carries so as to carry into effect, as to any given rates, any theory he might have as to what the stock ought to earn. So that, generally speaking, that is the way rates are made, without any reference to capitalization.

I want again to call attention to the very vital difference in this matter between railroad companies and other public service corporations like water companies, gas companies, street railway companies. These other public service corporations have a single commodity, and generally have a single rate. That rate, when fixed, determines their return.

With the railroad companies, it is entirely different. In the first place, they perform an infinite variety of services. The services divide pretty well, at the outset, between passenger and freight, radically different in every aspect.

When we come to freight, we find a vast variety of commodities. Of course, they may be classified so that a comparatively few rates will take care of all the articles that can be put in classes. But there are a vast number of commodities that cannot be put into classes. So that you have a very large number of different rates which the railroad company must charge.

In addition to that, however, you have a great number of different services, on account of the differences in haul. You do not have postage stamp rates for the railroad companies. They charge with some relation to distance. There are hundreds of thousands of different rates, I take it, due simply to the distance the commodity is hauled.

Then you have the matter of hauling commodities in different directions. The hauling in one direction may be influenced by some considerations, and the hauling in the other direction may be influenced by other considerations.

Then you have variations in volume, which go far beyond anything that could possibly arise with respect to a street railway or gas company. The railway company may have a set of rates, and on that set of rates, in a given year, it may earn a certain amount. You may assume a case where in the next succeeding year the total volume of traffic would be precisely the same, and the rates precisely the same, and yet

the earnings would be millions above or millions below what they were before.

That is due to changes in the volume of the different sorts of traffic, to changes in the distance the traffic was hauled, and changes in the direction in which the traffic is hauled.

A railroad company may be largely dependent, for example, on lumber as its revenue producer. Take the case of the railroads in the southeast, as I am rather familiar with that territory. One year there may be a very brisk trade in lumber, in the interior, in the Central States, like Ohio, Illinois and through there. There may be an enormous amount of lumber from the southeastern forests to that territory, and it brings good rates. The railroads may make a large amount of money out of it. The next year there may be a very great depression in the lumber business. There may be no demand for lumber. That forces down the price, and makes feasible a great export trade, by the south Atlantic ports and the Gulf of Mexico, that will either move over short distances by the railroads, or will move down the rivers, be loaded on ships and taken away. So that the revenue of the railroad company from that traffic may be very radically reduced, although its rates remain the same.

That is one of the countless instances as to how this matter may be affected.

A failure in the grain crop may make a radical reduction in the revenue of a railroad company, although its rates are the same.

I mention this, simply to bring the point to the attention of you gentlemen. It is unnecessary to go into great detail in illustrating the point, because I know you are very familiar with these conditions.

The fact remains, however, that all those conditions affect the railroad rates, and the railroad revenues, in ways which are never dreamed of with respect to other quasi-public service corporations. Therefore the regulation of the rates

of these other corporations is an infinitely more simple matter than the regulation of the rates of railroad companies.

I ought not to pass this branch of the subject without laying stress, also, on the fact that there is a vast variety of changing competitive conditions. It is a fact that, leaving railroad competition entirely out of the question, the competition of markets, the competition of commodities, the competition by water which is potential, if not actual, results in influences upon rates which cannot be controlled in advance, and which from time to time bring about changes in rates or changes in the direction of traffic, which have an effect upon the revenues to be derived at given rates.

It is apparent from what I have said, and, of course, it is already known to you, gentlemen, that it is absolutely impossible to ascertain the cost of any given service on a railroad. Of course, some great movements of traffic on a railroad may be approximated. For instance, take a company whose tonnage is largely coal, which moves in train loads. It may make a fair approximation of that, although it is beset with many difficulties. The division, even of expense, between passenger and freight is merely a series of approximations, and very difficult. It may, however, be approximated.

If you have a large traffic like coal in train loads, there may be a further approximation to get at that. But, take the miscellaneous traffic of a railroad company, and it is an absolute impossibility to get at the cost of the service.

If you assume that your volume of traffic were to remain constant; that your hauls would remain constant; that the movement of each sort of traffic would bear a certain constant relation to the total traffic—if you assume all these impossible things, you are still in a condition where you cannot make an apportionment of the cost of your service so as to make your rates produce, in the aggregate, a fair return or dividend on stock, or have any relation to your capitalization whatever.

Again, if you could figure all that out with the greatest care

and precision, if that were all possible, then you would be confronted with the commercial aspect, that on some of the traffic you could not get the rates you had assigned to that traffic, and on other sorts you could get more. So that, after all, after all the labor of making approximations of that sort, you would be thrown squarely back on the commercial situation with which the railroad is concerned, and that is to adjust the rates with reference to the character of the traffic. If the traffic is of such a character that very low rates can be made on it, it must be carried at low rates regardless of these other conditions.

In general it must be borne in mind that the question is essentially one of detail. When you come down to moving the railroad traffic, you have to have a rate on paper showing what you will charge for moving a certain thing a certain distance, and that rate has to be made with reference to the commercial conditions surrounding that thing. It seems to me it would be just as easy to prescribe a theory by which a man should lead a useful life as to prescribe a theory by which you shall make railroad rates. You can prescribe general theories, but when it comes to detail, to doing the thing each day, to deciding upon the conduct in a particular case, it is a question of good judgment under all the surrounding circumstances. And, as to railroad rates, one of the most remote circumstances which could be imagined is the capitalization of a given railroad company.

Heretofore all I have said has been upon the assumption that we can deal with a single railroad, and that if you could overcome these difficulties, that the rate situation could be dealt with according to some theory. The fact is, however, that as to the great volume of traffic in this country you cannot deal on that assumption at all, because traffic moves over different railroads which compete for it, and the rates must be the same, or have a relation to each other. The result is that that of itself would hopelessly upset any theory of making rates, if

everything else were out of the way. Take five or six railroad companies running between New York and Chicago, each with a different history as to capitalization, each with a different history as to everything that goes into the value of the property, and, if it were possible to overcome all these other difficulties, and as to any one of them work out a scheme of rates which had a relation to these things, the whole scheme would be hopelessly upset the moment you were confronted with the fact that the rates must be the same on all those railroads.

I wish to refer to this question of the general advances in rates, which is of interest right now, because the Interstate Commerce Commission is considering questions involving general advances of rates in Official Classification territory, and, to some extent, in territory west of Chicago.

It has been suggested that in these cases there has been a special reference to the capitalization; that the railroad companies have justified these advances on the ground that they have to raise the rates in order to pay their dividends, and in order to protect their surplus.

There is no disputing that that point is in the case; that different railroad companies have made that point, but even with respect to this class of cases, which is a comparatively small one as compared with the great bulk of the work of the Commission, this proposition is much more theoretical than practical, when you come to consider the action of the Commission.

The situation is that these railroad companies have been moved, in this matter, not by any consideration of their situation as to capitalization, but they have been moved by a desire to preserve, as far as they can, the status which has existed in the past. They have been confronted with advances in wages, which operate upon all of the companies. They have been confronted with other conditions which were of a commercial nature.

The result of that has been a general consensus of opinion that rates ought to be raised. When it has come before the Commission, each company, in turn, making its own showing, is bound to realize that its capitalization is a question which will be discussed ; that is, dividends will be discussed and its surplus, and each company in turn has sought to justify the returns when considered in the light of its own situation.

But that was not the moving cause which brought about the change. We find companies capitalized in the most conservative way just as anxious for the change and just as ready to justify it as companies which have suffered the most from over-capitalization. Capitalization is a circumstance in the case, I admit. It is a circumstance that the railroads wish to justify, and each company explains in the light of its own history and needs, the bearing of these inquiries upon its surplus and upon its dividends ; but that was not the moving cause for the advance. While I do not deny that it is a circumstance, I do wish to emphasize the fact that it is not the overpowering influence in the matter that might be assumed from the fact that prominence has been given to it in the hearings.

Here, again, we must not lose sight of the fact that the rates by different roads must be the same, and that, of itself, excludes capitalization as being the controlling factor in establishing what these rates shall be.

I submit, on this aspect of the case, that it would be absolutely impossible to devise any theory upon which rates shall be constructed. If you take the simplest class of cases, where the question is the narrowest, and that is the question as to whether the rates made by governmental authority violate the due process clause of the constitution, no theory could be safely established, even there, because the matter is not concluded by what the Supreme Court has said.

If you take the broader and practical situation of what

rates of the Interstate Commerce Commission violate the constitution or the statutes, you are still further removed from any theory, because you do not know what the courts are going to determine will be the considerations which will influence the courts in determining whether rates of the Commission are valid or invalid.

If you take the broadest of all the branches of the case, and the most important, and that is what theories are going to control the Commission in the performance of its responsible duties, why it is apparent that the Commission has the right and is charged with the duty to consider every reasonable element which the railroad company itself could consider.

So that any efforts to formulate a theory of regulations of rates, and from that theory of regulation to reason to a theory of supervision of capital, I submit, would be impracticable. It would not only be impracticable, but it would be exceedingly unfortunate. It would give a tremendous momentum to the idea that these commercial matters may be handled in a theoretical way. Unfortunately that idea prevails to a considerable extent already. This Commission, with its standing, charged with the responsibilities that it has, if it should put forth a report supporting a rate-making theory, would simply give a great momentum to an effort to manage in a theoretical way an essentially practical commercial problem which must be managed in a strictly practical way in detail as the separate cases arise.

The great misfortune about advancing in any way these theoretical methods is that they only work downwards, and never upwards. You take any theory and try to adjust railroad rates in accordance with it, and the popular pressure would never permit of a radical increase of rates by reason of that rule. The rates which could be made higher by the theory, would have to stand as they are. The rates which could be made lower by the theory would be lowered.

So that the practical effect upon the situation would be extremely unfortunate. I wish to suggest, further, and I am sure the points is in the minds of you gentlemen, that while this Commission is charged with very grave responsibilities, it has fortunately been spared the responsibility of formulating a theory upon which the rates of the railroad companies of this country should be constructed.

My conclusion, then, as to the effect of capitalization on rates is that while, theoretically, it is an element that may be looked to, yet practically it is an element that is not looked to in the great majority of cases; that in the cases where it is looked to, at all, it is very remote, and that while I do not see any basis for denying absolutely that it is an element in some cases, yet I think it is of the highest importance to lay emphasis upon the proposition that it is exceedingly remote, and that it would be unfortunate to give it a prominence in the public mind which it does not possess, in fact, and is not entitled to.

Effect of Capitalization Methods on Service and on the Ability to Raise Money.

I come to another element where capitalization may be regarded as having a bearing upon matters in which the public is interested, and that is as to the effect on service. That is entirely possible. If a railroad company improvidently exhausts its credit by issuing bonds to the full extent of its credit, has liens on its road so that it can put no more on it, and uses the money improvidently, it is apparent that when the need comes, from time to time in the future, for that railroad company to raise more money to improve its public service, it will be handicapped by its improvidence in the past.

I do not think there is any dispute in that regard, and I think that from a practical standpoint that is decidedly a

sounder position than any position with regard to the relation of capitalization to rates.

Even here, however, it is a matter that is easily exaggerated. It would rarely have any effect, except as to bonds. Generally speaking, if there were over-issues of stock, that would not interfere with the railroad companies borrowing money, because their indebtedness would come ahead of their stock. It is an element which would play a part with respect to bonds. Generally speaking, however, bonds are issued only for value, and consequently the matter is one that has not the practical importance that might be given to it if it were made unduly prominent in any consideration of this subject.

Of course, even there, the matter of competitive service has some bearing, but it does not begin to have the effect that competition has upon rates. Rates have to be absolutely the same by competitive lines or according to established differentials, whereas there is not the same absolute uniformity in service, and yet competition has an influence upon the service.

So that, while I freely admit that that is a practical element, and one worthy of consideration, I do want to lay stress upon the fact that it could easily be exaggerated, and create an impression which is contrary to the facts; because, generally speaking, I do not believe that there has been any impairment of service on that account, although such impairment might arise, and may have arisen, in special circumstances; but, I think those circumstances would be found very exceptional, if you should consider the service of the railroads of the country as a whole.

Then there is the still broader aspect of the matter that has been considered or will be considered, and that is that, aside from any specific service on the railroad as it stands, it is to the interest of the public that money should be attracted to the railroads. There is a vast amount of improve-

ment needed on the railroads of this country, even as they stand. It is to the public interest that money should be invested in the railroads, and it is to the public interest that practices should not be indulged in by the railroads which would discourage the investment of money in them; and hence it is to the public interest so to regulate future capitalization as to prevent those practices. That is a very broad aspect of the matter that has been urged, and I mention it because it has been urged, and I concede that it is, at least theoretically, a matter not without force. As a practical matter I think it will be found that the sort of over-capitalization that has been done has not had that effect, and a railroad company charged as it is in these days with the necessity for improving its service, being so thoroughly alive to it, and being so beset by public demands that its service shall be improved, it is not likely to impair its credit unnecessarily.

Now, in general, on this subject, it would be difficult to deny a theoretical relation between the capitalization of railroad companies and these various aspects of the matter that I have mentioned. But, generally, that relation is not practical. Almost always it is very remote, and has almost no bearing.

Regulation Should be Based, Not on Any of These Factors, Practically so Independent of Capitalization, but Upon the Ground that Congress May Regulate the Activities of Instrumentalities of Commerce.

I would like to submit this aspect of the matter to the Commission. I have thought a good deal about it, and I believe it fairly states the situation. I think the true situation is this: That the public resents obviously improper practices on the part of the railroad companies with respect to capitali-

zation. The public feels, and properly, that the railroads are quasi-public institutions, and any obviously improper action with respect to capitalization arouses public resentment. One or two instances of grossly improper conduct would arouse very general resentment, and the public wants to control the matter, to prevent those things. There, I believe, is the basis of the thing. I do not believe the public has started at it from the end that rates are too high because of capitalization. I think the public has started at it from an instinctive resentment at improper methods.

That being true, there has been a theory that Congress could not regulate this matter unless a connection with rates should be established. Consequently, in order to justify the regulation which the public wants, there has been a very studied effort to establish a connection between rates and capitalization, and the result is that the real connection has been very greatly exaggerated. For my part, I do not find that trouble. I fall back on my original proposition that the object of a railroad is to provide a channel for commerce, and that the power of Congress to regulate commerce is so broad as to apply to any operations of a railroad company which engages in commerce among the states.

I believe that is the true ground to base this regulation on. I do not believe anything is gained by attempting to narrow it to anything like the regulation of rates in particular; and I think the greatest misfortune would result from such a narrowing, because it would stimulate still further the popular misconception that there is a vital connection between capitalization and rates, and that a supervision of capitalization is going to lead to a general reduction of rates.

The Character of Regulation that is Expedient.

I do not feel at the present time, in a position to make any valuable affirmative suggestions as to the best character of supervision of capitalization. My suggestions now will be

more destructive, or rather suggestions of what to avoid than what to do. At a later time I hope to be able to do something that will be more helpful than that.

As to the character of federal supervision, of course the question arising at the outset is: What are the existing evils? I think the answer to that is that there are very, very few.

We must remember further, that such things as have been done in the past that are the subject of criticism, were done practically without any supervision of governmental regulation whatever, and at a time when the public was paying practically no attention to these things, when there was practically an invitation to, and an acquiescence in, people's doing what they pleased in these matters.

Undoubtedly conditions in that respect are greatly improved at the present time. The railroad companies are subject to a public scrutiny, not only by the Interstate Commerce Commission but by public officers generally, and by the public generally, which they have never been subject to before. They are charged with a sense of responsibility which is keener than it has ever been before.

I think the result of those things and the general trend toward improvement render the prospect of any improper financing which would be the subject of criticism far less now than it was in the past. In fact, those conditions are such that a great many gentlemen will appear before you and will say, with the utmost good faith, and I think with a great deal of reason, that, viewed from the standpoint of preventing wrongs, there is no necessity to have any supervision; that conditions are to such an extent above criticism at the present time that nothing is necessary; and I think there is a great deal in that view.

My personal disposition is that the occasional wrongs that have been committed have made such an impression on the public that probably some supervision will have to be made, and

personally I do not care to put myself in the position of opposing it ; but I mention the fact that, on account of the tremendous contrast between present conditions and the conditions which existed when capitalization methods subject to criticism took place in the past, certainly a much milder form of regulation would seem to be necessary now than would seem to have been necessary in the past.

One of the most important conditions that we must deal with in connection with this subject is the fact that it is of the highest importance to the public to attract capital to invest in the railroads of the country. Of course the need of additional railroads in certain sections of the country is apparent. A thing less apparent, but perhaps even more important, is the need of raising enormous sums of money to spend on the railroads which already exist, in order to keep them abreast of the progress of civilization.

I have recently stated, in a published article ("The Outlook," Dec. 10, 1910), that on the Atchison, Topeka and Santa Fe Line, probably from twenty-five million dollars to thirty million dollars a year of new capital could be spent on the property to the advantage of the public, and would be spent if conditions were such as to admit of our raising that amount and taking care of the charges upon it. Perhaps twenty million dollars or more of that amount per year would be to improve our existing lines as distinguished from constructing new lines.

The lines are in good condition, but they must be put in constantly better condition, and a great variety of things must be done to keep the service up to the increasing demands of the public. This necessity of raising new capital to improve the service on existing railroads is of paramount importance ; and any scheme of supervision, I think, ought to start with that ; that there is a thing of the most profound practical importance to the public, and that concessions to

theoretical ideas about regulations ought not to be made which would impair or interfere with anything so practical and so important.

Then we come to consider the probable course of financing by railroad companies, and I think the matter divides itself about in this way: There are a large number of railroad companies having important interests at the present time whose interests are such that there is no chance worth considering that financing will be done by them which would invite public criticism in any way. They have too much at stake. Their record is such as to show that such practices are not indulged in by them. Moreover, they are subject to public scrutiny, and the possibility of improper financing in the great bulk of the railroad companies of this country has got about to the vanishing point, I think.

Moreover, most of those companies are in a position to finance and do finance on lines which would be permissible in any scheme of regulation which would be provided. As to them the difficulty would be that they would be subjected to delays and uncertainties which would involve increased expense in financing, without any good to the public.

As to a great many companies in that position this element cannot be overlooked. A drastic form of regulation would hurt them only in that it would make the financing a little more uncertain and expensive and troublesome; but, along with that would come the financing of new corporations and that may be made almost out of the question. Hence, the existing companies may have the consolation, that they would be left, in the future, to develop their systems freer from competitive construction than they have been in the past. That is a condition which is of very practical importance and deserves the most serious consideration.

Then we have existing companies which are not in a position to finance on the most favorable terms. The ques-

tion is whether a form of regulation shall be adopted which will make their financing even more difficult, and if so, whether that is in the public interest.

Then we will have new companies proposing to construct new enterprises in certain parts of the country, which it is of the highest importance should be developed, and the question is whether a form of regulation should be adopted which would discourage that character of construction and leave construction to the established companies.

It seems to me that the argument as to all three of those classes, which cover practically the whole question of legitimate railroad operations, is that a form of regulation which is more drastic than the situation absolutely requires is contrary to the public interest.

Then we come to the fact that there is a practically negligible class of cases or instances where there may be an improper financial transaction, and the question is whether, in order to prevent that possibility, things will be done which will impair the public interest in all these points of main interest.

There is just one other point that I wish to mention, and that is the administrative side of the subject.

The more drastic regulation is made, the more administration is required on the part of the government. Now, in my opinion, one of the most vital interests to the railroads of this country is that there shall be efficient governmental regulation; because, if a scheme of regulation shall be adopted that turns out to be inefficient, the discontent on the part of the public is going to react upon the railroad companies themselves; and in the long run, the railroads will bear the burden which comes from the inefficiency of the public regulation. That being true, the railroad companies have a vital interest in the regulation being efficient.

So that I urge, with especial emphasis on the Commission,

the proposition that a scheme of regulation ought not to be adopted which will impose unnecessary burdens upon the administrative officers of the government.

The Interstate Commerce Commission is now charged with most enormous responsibilities and burdens, and it is of the highest consequence to the railroad companies that the Commission shall be able to discharge its functions in accordance with the spirit of the statute. For that reason I think, purely from the administrative side of the situation, it is vastly important that this Commission should not adopt a scheme of regulation of capitalization which will render still more difficult the administration of laws of the country on this subject.

I wish also to refer to the subject of so-called physical valuation. In the first place I think that is an unfortunate designation of the subject, because it implies that there are no elements of value in a railroad property except those of a strictly tangible sort. I understand the argument that in valuing a railroad for public purposes there ought not to be an additional value on account of the rates that it earns, because you then argue in a circle; you give it a value on account of its rates, and then give it high rates on account of its value. I realize allowance must be made for that. But eliminating that element there is a value to the element of a going concern which I think is entitled to consideration. I am not going to undertake to discuss that at length. I mention it simply in passing.

Now I wanted to refer briefly to an official valuation with respect to capitalization. As to that my suggestion is that there is no relation between an official valuation of railroads and the regulation of their future capitalization.

Take as an illustration an assumed case of a railroad company which has outstanding bonds of one hundred millions, and outstanding stocks of one hundred millions, making its total capitalization two hundred millions. Assume that an official valuation of two hundred millions is placed on that

property. That company will undoubtedly have to raise large amounts of money to improve its existing lines. Assume that it wishes to raise fifty millions additional. The fact that its existing capitalization is already equal to its existing official value has absolutely no bearing upon the propriety of its issuing additional capital for new money to the same amount. I have been unable to think of any proper connection between an official valuation and a company's capital issues. If it gets money or property for its new issues I think that is all that is required, and, in fact, it is of the highest importance to the public that it should be able to raise all the additional capital needed even when its present capitalization equals its present value.

I understand they have in Texas a peculiar rule that a company shall not issue either stocks or bonds beyond the official valuation of the Texas Commission. The result is that a company down there is utterly helpless, standing on its own merits, to raise money to improve its own roadbed. It cannot issue either stock or bonds because its existing capitalization is up to its valuation, which, of course, is the proper place for it to be. It seems a very unwise provision. The result is that railroad companies in Texas are practically all merely subsidiary companies of systems outside which have to do the financing for the Texas companies, and which get neither stocks nor bonds of the Texas companies for the financing done so far as it relates to the future improvement of existing mileage.

I wish to emphasize that in my opinion it is not desirable to adopt or maintain any certain relationship between outstanding securities and physical or official values. I do not see how it is practical; and if practical, I do not see what would be accomplished, because if the new securities that are put out bring new money into the property, you have the money, if you have not the property, in your tangible values. Any effort to establish a relationship between the issue of new

securities and the physical value of the property would prove a serious handicap in railroad financing. When a railroad company comes to raise new capital it is of the highest importance that it should be able to act when the money market is favorable and to take advantage of favorable times to finance for a very considerable period into the future. Unless a wide discretion is left to the board of directors in this matter, and if the board is confined to a comparatively narrow margin so as to maintain some prescribed relationship between new issues and present physical values, the result will be that the board when the money market is favorable will be seriously restricted as to what it can do and then will be forced to do additional financing subsequently when money conditions may be very unfavorable, and perhaps may be forced to raise money on short time notes, which is an exceedingly expensive and unsatisfactory method of financing. On this point I emphatically advise that when the money market is favorable a railroad company should be allowed to raise all the new capital which it can raise and which its board of directors think it is desirable to raise. If the money is honestly raised and expended the public can have no cause for complaint.

The other question with respect to an official valuation is the relation to the rate-making function. I do not need to discuss that at great length, because in a general way much that I have already said about the relation of capitalization to rates applies to the relation of an official valuation to rates. I do appreciate, and fully concede, that when a Commission undertakes to make rates an official valuation of the property would be of interest to the Commission, because a fair return upon that valuation would be the minimum below which the Commission probably could not constitutionally go. In other words, it would be an aid to the Commission in pointing out how far it might go in the way of reductions of rates. It would not be an aid to the Commission in pointing out the broader question, consid-

ering all the circumstances which reasonable people ought to consider, what rates the company could properly charge, and whether any of its rates, although producing more than a fair return on this official valuation, are so high as to violate the prohibition of the law against charging other than just and reasonable rates. But it is true that a valuation of railroad property has been treated as a basis for testing the constitutionality of rates, and that a Commission charged with the responsibility of fixing rates would be interested in knowing in an official way the valuation of the property, so as to know the point below which the Commission ought not to go. Of course, a valuation entered on for that purpose would be rather ominous, as being open to the construction that the public policy is to cut railroad rates to the minimum, and that that is the reason it is desired to find out how much the Commission can constitutionally do to the railroads.

But I am inclined to think that an official valuation of the railroads is another thing that the public is very much interested in, and, as it is undoubtedly a factor that marks one boundary of the Commission's activity, I do not see how it can be opposed absolutely, but I do think anything done in that direction ought to be done with a clear understanding of the function of a valuation after it shall have been ascertained.

In that connection, I prepared two or three years ago, but did not publish, a pamphlet of about eleven pages dealing with the question of valuations, perhaps a repetition to some extent of what I have said here this morning and this afternoon, and I shall leave a copy with the Commission.

Now, coming to the matter of a suggested form of supervision, as I said before I am hardly in a position now to make any constructive suggestions, but I will say that my general inclination at present is that in view of contemporary conditions a scheme providing for adequate publicity of railroad financing would serve every purpose to insure the honest raising and honest spending of money which was

raised by railroad companies. I think if those things are accomplished that the real interests of the public will be met.

In connection with any such plan I would suggest the importance of what Judge Lovett referred to this morning, and that is the avoidance of any unnecessary disclosure in advance of the plans of the railroad company. He referred especially to their negotiations for the sale of their securities. Of course, the more they can have that in their own hands the better terms they are likely to be able to make. There is still another side to it, and that is if the company is required to make public in advance the purposes for which it wishes to spend the money it is put at a very great disadvantage. For example, a railroad company may find it necessary to spend several million dollars for terminals in a given city. Now if it has to be made a matter of public record in advance that it proposes to spend five million dollars for terminals in a given city it will be vastly more difficult and more expensive for it to get terminals in that city than if it can go on and buy the land at its current market value before any such notice is given to the public.

The same thing is frequently true when a company proposes to build an additional line. If it is known that this line is to be built by a strong company, assumed to have plenty of money, a great many more difficulties will be put in the way, and a great many more difficulties will be incurred than if the line can be built on the footing of an ordinary proposition. So I think adequate publicity could be secured, so as to obtain what is desired in the public interest without putting the railroad company at disadvantages which would result simply in its expenditure of additional money, and in that much more of a burden on the public for the future.

Another point I will mention in conclusion:—the question of the expenditure of proceeds. I think it is entirely proper that that should be made very full and clear, but, as Judge Lovett pointed out, the money is not ear-marked. Here is the condition that the railroad company is in. It has sur-

plus earnings, say, of five million dollars in a given year. It raises in that year, say, twenty million dollars on securities. The result is it has twenty-five million dollars which it spends indiscriminately for capital account, and there is no way, without unnecessary embarrassment and loss, to separate those two funds, and to hold one for certain purposes and the other for certain purposes.

It occurs to me that the whole situation would be met by having a clear statement on the part of the company as to what it has received from capital issues, and what it has received from earnings, and what has been spent on all accounts, and a detailed statement of what has been spent on capital account. That would include what had been spent for capital account, whether derived from earnings or from capital issues. I concede that there should be a clear statement which would follow promptly on the event, as to what in fact had been spent for what would be called capital expenditures in the accounting sense, and what additional securities had been issued and sold to the public.

The following is the article mentioned in the foregoing statement and filed with the Railroad Securities Commission :

VALUATION OF RAILWAYS AS A BASIS OF RATEMAKING.

A subject of current discussion is the advisability of providing an official valuation of the railways in the United States. The purpose suggested for such a valuation is that it would supply the Interstate Commerce Commission with a basis for making reasonable rates. The most definite suggestion as to the character of the valuation is that it should be an appraisal of the physical properties of each railway company

based on what it would now cost to reproduce those properties. The only definite suggestion as to the use to be made of the resulting figures is that the rates should be so fixed on the principle that no railway company should earn more upon such a valuation than a return approximating the usual rates of interest.

It is believed that the fair ascertainment of the cost of reproducing the physical properties of the railway companies will show that even on that basis they are earning very moderate profits. But, as a matter of principle, it is important to point out that such a valuation could not in any event furnish any just or practicable basis for revising rates, because the doctrine that a railway company should not be allowed to earn more than the ordinary interest rate upon the cost of reproducing its physical properties has no judicial or legislative sanction and would be highly unjust and impracticable.

There is no common law or statutory principle that railway rates shall be adjusted so as to produce not more than a fixed return upon the value of the railway company's property. At common law the reasonableness of rates depended not on the profits of the common carrier but on the question whether the particular charge was a reasonable or unreasonable exaction for the service rendered. A carrier's charges if otherwise reasonable did not at common law become unreasonable because the carrier was so fortunate as to have a large business and enjoy large profits. There is no statutory declaration or legislative policy changing the common law in this respect. Legislative reductions of rates have generally proceeded upon the belief that the rates reduced were unreasonably high as compared with other rates.

It is true the courts when considering legislative rate reductions have shown a disposition to uphold such legislative action where there was left to the railway company a fair return on the present value of its property, but in so deciding the courts have merely suggested that beyond this point the

protection of the fair interests of the railways might rest with the legislature and not with the courts. The courts did not hold that it was a duty of the legislature, or just or expedient for the legislature, to reduce rates to any basis of valuation. Nor have the courts held that for purposes of judicial intervention the present value must be restricted to the mere cost of reproducing the physical property, or that the fair return must be restricted to the usual interest rate.

If, therefore, railway rates are to be regulated on the theory that Congress ought to provide for changing them from time to time so as not to produce more than a return approximating usual interest rates upon the value of the physical property of the railway companies such theory of regulation will be entirely different from recognized principles and will call for the formulation of a new legislative policy.

There is a wide margin of purely legislative discretion as to rate reductions with which the courts cannot interfere ; within that margin are vast possibilities of injustice which the courts can never remedy ; within that margin Congress is under a moral and constitutional obligation to do what is just and expedient. Would it be just or expedient or even feasible for Congress to adopt the novel policy of providing for the reduction of railway rates on the basis of restricting returns so as not to exceed a return corresponding to the usual rates of interest upon the valuation of the physical properties ?

To restrict a railway company to a rate of return approximating the usual rates of interest would be exceedingly unfair. The usual rates of interest represent the price investors are willing to accept for the use of their money when loaned on adequate security. In such cases the lender obtains reasonable assurance of a definite and steady return paid periodically, and of a repayment of the principal sum at maturity. The business in which the money is used is conducted by the borrower and at his risk. A man who at his own risk puts his money

into an industrial or commercial enterprise which he has to manage or supervise is always regarded as entitled to a return much in excess of the usual rate of interest because he takes much larger risks and incurs greater cares than the man who merely loans his money on good security.

Very few industrial enterprises are more hazardous than the railway business and none requires a higher degree of skill and ability in its management. A railway when once constructed cannot be abandoned or moved and must be operated regardless of adverse conditions. The railway business is peculiarly subject to commercial and industrial vicissitudes. Crop failures or general financial depression are reflected very quickly in radical losses of railway earnings. For the year ending June 30, 1892, the railways of the United States after paying operating expenses and taxes realized approximately \$2,195 per mile. Two years later the corresponding earnings per mile were \$1,729, a loss in two years of nearly twenty-two per cent. A very large proportion of all the expenses of a railway company is practically independent of the volume of traffic, so that expenses are ordinarily proportionately higher in times of adversity than in times of prosperity. Railways are becoming increasingly subject to heavy taxation, burdensome legislative requirements and expensive litigation. Railway property is peculiarly exposed to damages from floods and other natural causes. One important railway system has recently suffered damages from floods to the amount of two million dollars in fourteen months. Railway property is subject to rapid depreciation and much of it may from time to time have to be discarded on account of the necessity of adopting new or improved types of machinery or material. No railway company can be properly managed without setting apart in prosperous years a very large part of its net income as a reserve fund. In many years conditions may be such that the railway companies cannot earn the usual rate of interest. Certainly they should be allowed, if they can,

to earn a sufficiently large income in prosperous years to protect themselves against these contingencies, provided this can be done without imposing rates that are in themselves unjust. If the Government proposed to guarantee that the railways should not earn less than the usual interest return, there would then be some fairness in proposing to prohibit the railways from earning more when that is possible without charging excessive rates.

To restrict the income to the present reproduction cost of the property would, in many cases unfairly ignore the original cost of the property. If a railway company is charging rates which are not in themselves unreasonable, it is proper and desirable that the company, if practicable, should earn enough money to pay a return upon all the capital which has been invested in the property legitimately and in good faith, even if the property could now be reproduced for substantially less. About twenty-five years ago, a railway was built through a sparsely settled region in one of the southern states. The venture was uncertain, and to raise the money for construction it was necessary to issue seven per cent. bonds, and sell them for ninety cents on the dollar. The high cost of labor and materials made the road very expensive to construct. The money was honestly raised and honestly expended, but the cost was necessarily far in excess of the present cost to reproduce the property. The building of the railway was of great value to the people, affording them much better and cheaper transportation facilities than they had ever had before. If the rates charged on that railway are not in themselves unreasonable, the owners of those seven per cent. bonds should not be deprived of a part of their investment by a cutting down of the rates on that railway so as to prevent it from earning more than a small return on the present cost of production. It is conceded that excessive original cost as compared with reproduction cost should not be made the basis for charging rates in themselves unreasonable,

but it is earnestly insisted that rates which in themselves are not unreasonable should never be reduced merely because the reproduction cost is less than the legitimate original cost.

A valuation of the mere physical property of a railway company ignores valuable property rights upon which the company should be permitted to realize a return if it can do so while charging rates not in themselves unreasonable. Advocates of the physical valuation basis say any other elements of value depend on earning capacity and that earning capacity cannot be considered because that depends on the rates which can be charged ; that an exceptional earning capacity may be due to unreasonable rates and in that event a value based on earning capacity would perpetuate those unreasonable rates. This argument ignores the fact that earning capacity depends not alone on the rates to be charged, but also on the business to be moved. The right to charge a given rate is of no value unless there is traffic to move. The enjoyment of a large business is an element of property which is entitled to protection.

A water company obtained a franchise, constructed a system of water works and supplied water to the residents of a city. The franchise expired, the city sought to obtain the company's property, and the question arose as to the fair and equitable value of that property. The United States Circuit Court of Appeals in an opinion by Mr. Justice BREWER, held that the fact that the system had water-pipe connections with a large number of houses, and was a going concern with established customers, was a distinct and important element of value in addition to the value of the mere physical property, notwithstanding that the right to charge rates for the distribution of the water had entirely ceased.* The same principle applies to a railway company, and with greater force, because

* National Water Works Co. vs. Kansas City, 62 Fed. Rep., 864.

the railway company's right to do business at legal rates is a continuing right.

As the physical property of a newly constructed railway comes from the hands of the contractor its practical value may be very dubious. The local traffic is small and irregular and expensive to handle. The profitable traffic is that which moves regularly, in large quantities, over considerable distances and is principally created by the untiring efforts of the railway company in promoting the development of agricultural resources, the opening of mines, the establishment of mills and factories, arrangements for warehouses, elevators and docks at terminal points, and the formation of traffic arrangements with connecting railway and steamship lines. Every additional step in this work increases the value of the railway company's property. When a mill is established, both inbound and outband traffic are created, the volume of traffic is increased and the relative cost of handling the traffic is thereby diminished. Much labor and time are required to build up this traffic, and often many years must elapse without adequate return before a paying business can be built up.

Let us assume two railways of equal length, substantially similar in physical characteristics and the cost of reproduction. One railway may have been in operation for thirty years and may have built up an enormous traffic. The other railway may be new and may have very little traffic. These two railways cannot be of the same value for purposes of railway rate regulation. To establish rates on the theory of giving equal returns to these two railways would probably necessitate rates on the new railway several times as high as the rates on the old railway. The old railway has an exceedingly valuable good-will which belongs to its stockholders in as real a sense as does the roadbed and is equally entitled to protection. It is true that the value of the good will is, in a sense, dependent on the rates charged, but so is the value of

the roadbed. The roadbed has practically no value except for railroad purposes, and that value, just like the value of the good-will, is influenced by the rates charged. The argument that the good-will cannot be considered because its value is affected by the rates charged would equally exclude from consideration the value of the roadbed itself.

But if a fair valuation of the railway property and a fair return thereon have been established no real progress has been made towards the equitable revision of rates. There are thousands of different articles of traffic moving between thousands of different points at thousands of different rates. These varying rates cannot be adjusted to each other on the basis of cost of service plus a profit to the carrier, because the cost of performing any specific transportation service cannot be separated from the general cost of performing all transportation service. The expenses of a railway company include the cost of maintaining a general organization for all traffic, of maintaining a roadbed for all traffic, of maintaining and running locomotives and freight cars for all freight traffic, and locomotives and passenger cars for all passenger traffic. Much of the property is used indiscriminately for passenger and freight traffic and many employees devote their time indiscriminately to the two. Practically none of the property can be said to be used exclusively for either and practically no property or labor can be said to be devoted exclusively to the movement of a specific article between two specific points. No one has ever devised a method for accurately dividing the expenses between passenger traffic and freight traffic. It is even more impracticable to ascertain the cost of running a particular freight train, and it is hopeless to attempt to ascertain the respective costs of transporting different articles in the same freight train. No one can tell what is the cost of switching a carload of brick from a brick kiln to a team track as compared with hauling a carload of pig iron for 500 miles, or as compared with haul-

ing a car partially filled with miscellaneous merchandise in small consignments to various local stations. A railway company may for a haul of 400 miles in carload lots charge \$2.50 per ton for coal, \$3.80 per ton for lumber and \$18 per ton for boots and shoes and may have all these commodities and also empty cars in the same train, but no one can tell the relative or absolute cost of any of these services.

Even if it were possible to ascertain the respective costs of transporting different articles, it would be impossible commercially to adjust rates on the basis of such cost. The difference in rates between dry goods in carload lots and stone in carload lots is much greater than the difference in cost could possibly be. If the rates were revised so as to be proportionate to cost, either the rate on stone would be so high that no stone would be shipped or the rate on dry goods and similar commodities would be so low that the railway could not earn enough to pay operating expenses. It is a recognized commercial necessity that the rates must be so adjusted that cheaper sorts of commodities will not be charged more than they can pay. Much of the differences in rates is due to this inexorable requirement.

Every attempt to fix rates according to cost has been abandoned and rates continue to be adjusted on commercial principles. A reduction of rates on the valuation basis could not, therefore, be apportioned between different rates on the basis of a fair profit as to each commodity. Either the reduction would have to be a horizontal reduction of the rates on all traffic, passenger and freight, or particular kinds of traffic would have to be selected, without regard to fairness of return, to enjoy all the benefit to which all the traffic would be theoretically entitled. Surely no theory of rate revision can be sound or just when the cause of the reduction has no relation to the reduction actually made.

Suppose a railway company for the last fiscal year had gross earnings of \$1,000,000 and that its operating expenses

and taxes amounted to \$700,000. This would leave \$300,000 which will be called net income, for interest, dividends and reserve fund. Suppose it should be determined by the valuation method that the net income should be cut down to \$240,000. This would mean a reduction of twenty per cent. in net income. Such a percentage of permanent reduction in net income would probably be enough to destroy the credit of any railway in the country and make the raising of additional capital impossible. Yet the reduction would be only six per cent. of the gross earnings. What would be the result of a horizontal reduction of six per cent. in rates? This would mean a reduction in a three-cent passenger rate of 1.8 mills per mile; would make a rate of 94 cents in place of a rate of \$1.00 per ton for coal, which would mean a reduction of about two mills per bushel; a rate of 14.1 cents per 100 pounds for wheat would replace a rate of 15 cents, which would mean a reduction of about 5 mills per bushel. Such rate revision would produce the utmost confusion in tariffs, would be wholly impracticable and, if it were practicable, the entire reduction would be absorbed by the middlemen. As a matter of fact, no railroad commission would undertake rate reduction on any such impracticable basis but would undertake to reduce those rates which were relatively too high. In other words, the commission, forced in practice to abandon all thought of the fairness or unfairness of the profit, would proceed in exactly the same way in which it can now proceed to readjust rates so as to correct relative injustice in the light of the history of the rates involved, and of a comparison of those rates with other rates and in accordance with commercial conditions.

Almost all railway rates are, in some sense, competitive. Coal mined at a local point on one railway competes in a common market with coal mined at a local point on another railway. Phosphate rock produced in a territory local to one railway may compete in the markets of Europe with phos-

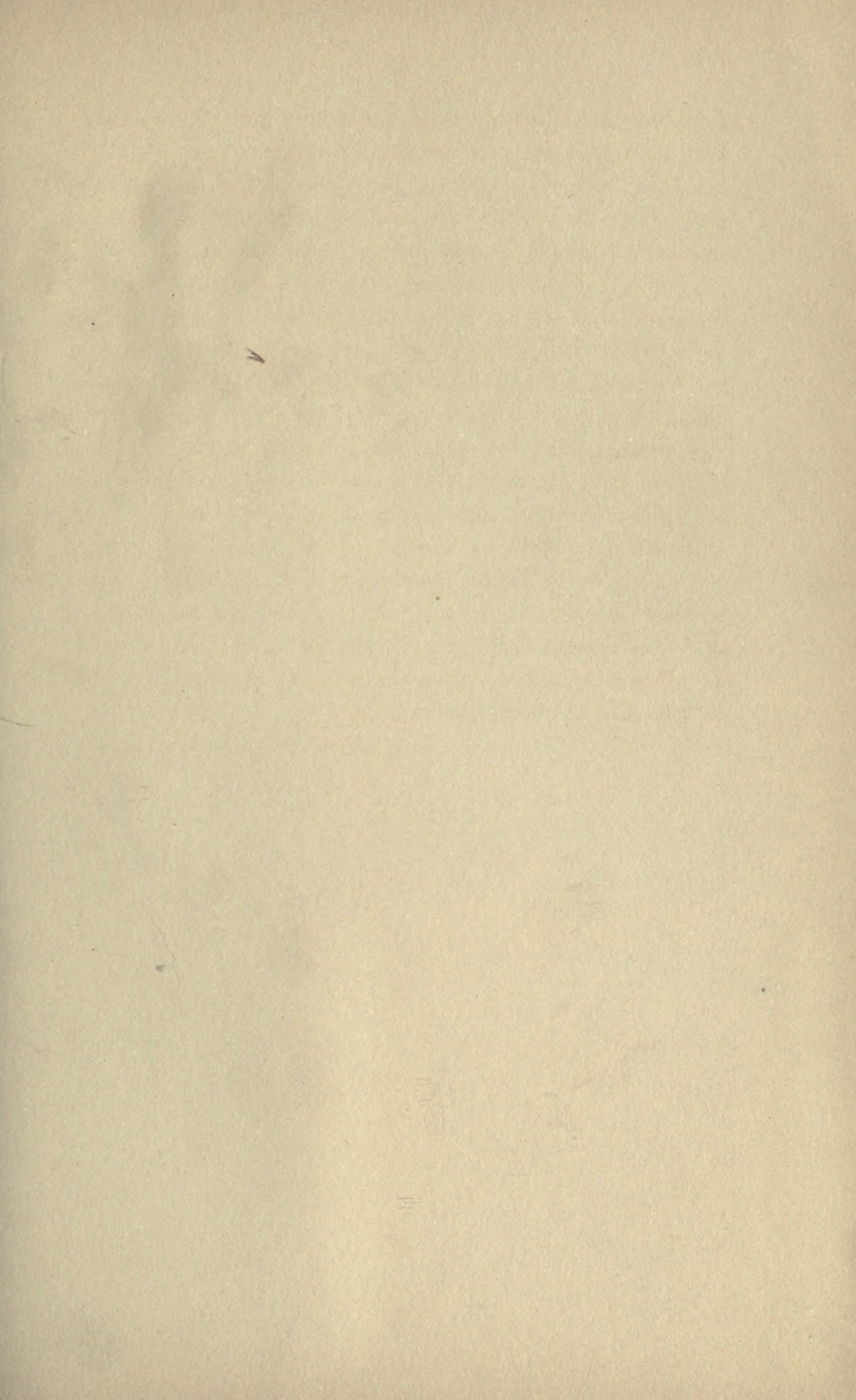
phate rock produced in a widely separated territory local to another railway. A reduction of rates upon one railway upon the theory that such reduction is necessary to prevent such railway from realizing more than a fixed return upon the value of its property will, in almost every case, force a reduction in rates on some other railway which may not be earning such a return. If the other railway does not meet the reduction, it loses the traffic and the localities dependent upon it are put at a disadvantage in competition with the localities upon the more prosperous railway. This condition of the interdependence of rates regardless of the fair value of the respective railways charging those rates would entirely defeat the consistent application of the principle of making rates according to any theory of a fixed basis of return to the railway.

Fluctuating traffic conditions would quickly disarrange any adjustment of rates based upon the theory of limiting rates to an established return. Net results of railway operations are largely influenced by the particular direction or character of the principal traffic carried. A comparatively short railway may in one year make its principal returns out of a movement of lumber to interior markets, and the next year may be deprived of that source of revenue if the movement of lumber from its territory is largely for export and moves in the opposite direction. A few years ago railways which habitually carried large amounts of grain east-bound found on account of crop failure that there was no east-bound movement but that they had to carry some grain westbound ; besides reducing gross earnings this unusual condition probably destroyed the usual balance between east-bound and westbound traffic so as to increase the cost of operation through unusual movement of empty cars and otherwise. A company largely dependent upon the production of pig iron may on account of furnaces going out of blast have its principal source of revenue temporarily destroyed. Such

situations might readily cause a great reduction in gross earnings and a great relative increase in the cost of operation. The result of fluctuations of this character might be that the company would be entirely deprived of the revenue which the commission assumed would give it the fair return.

It is believed the foregoing considerations show that the suggested rate revision based on valuation is unfair and impossible; it contemplates only a very limited return in prosperous times and provides no guaranty against adversity; it ignores money honestly invested and fairly entitled to a return if rates are not unreasonable; it ignores important elements of value in the property; and if it should bring about reductions at all they would be aimless, not required by commercial conditions and inconsistent with commercial stability. No such novel rule is required for the protection of the public. Every unreasonable rate can be corrected as the law stands to-day and would continue subject to correction in the same way, and no other, despite any attempt to resort to the valuation basis as a method of affirmative regulation.

WALKER D. HINES.



PLEASE DO NOT REMOVE
CARDS OR SLIPS FROM THIS POCKET

UNIVERSITY OF TORONTO LIBRARY

HE
2236
H55

Hines, Walker Downer
Statement of Walker D.
Hines

